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No. 03-539

In The

Supreme Court of the United States

WESTERN WIRELESS CORPORATION,
Petitioner,

v.

DEPARTMENT OF REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of South Dakota

PETITIONER'S REPLY BRIEF

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SUMMARY

The issue in this case is whether, consistent with the Commerce Clause, a state may tax a purported in-state "use" of services when (a) they are purchased and performed entirely outside the taxing state, (b) the purchaser of the service performs no act in the taxing state to "use" the services there, and (c) the state has already imposed its sales tax on 100% of the taxpayer's activities within its borders. The significant differences between the nature and use of services – compared with the nature and use of tangible personal property – prevents this Court's prior Commerce Clause jurisprudence from serving as a reliable guide to lower courts in the increasingly important area of use taxes on services. As a result of misreading how the Court's prior cases should apply to such taxes, the South Dakota Supreme Court has issued an opinion that improperly taxes extraterritorial activity and impermissibly subjects interstate commerce to multiple taxation. Certiorari should be granted to clarify the states' permissible reach in taxing the "use" of out-of-state services before more states, like South Dakota, overreach their authority under the Commerce Clause.

ARGUMENT

A. The Commerce Clause prohibits taxes like South Dakota's, which are imposed on events that take place in other states, and which subject interstate commerce to multiple taxation.

1. The Opposition confirms the key events.

Respondent's Brief in Opposition, like its tax, depends upon an implied "use" by Western Wireless of the billing services CSC performs entirely in other states. Br. in Opp. 10-11. As the Opposition confirms, there is no dispute about the actual events and activities of the service provider or the taxpayer (Br. in Opp. 2-3; Pet. 3):

a. What happens in other states?

- Western purchases CSC's billing services at Western's place of business in Washington State.
- CSC's services are performed entirely in Illinois and California.
- Western receives and uses CSC's services (i) in Washington State, where Western manages the billing activities and Western receives, reviews and approves CSC's draft bills, and (ii) in Arizona, where the payments on the bills are received and processed.

b. What does not happen in South Dakota?

- Western does not purchase CSC's billing services in South Dakota.
- CSC does not perform any part of its services in South Dakota.
- Western performs no act in South Dakota that is a "use" of the services – i.e., a taxable event – in South Dakota.
- South Dakota provides no government services or protections to CSC's business activities, which are performed entirely in Illinois and California.
- South Dakota provides no government services or protections to Western's activities making use of CSC's billing services, which activities Western performed entirely in Washington and Arizona.

c. What does happen in South Dakota?

The only events in South Dakota (relevant to the out-of-state billing services) either have already been subjected to the state's sales tax or have been held not subject to its use tax as a matter of state law:

- Some of the paper bills that result from CSC's services in Illinois and California are received via mail by Western's cellular phone subscribers in South Dakota. The South

Dakota courts ruled, as a matter of state law, that Western did not exercise dominion and control over those bills so as to constitute a use in South Dakota. App. 6a, 26a.

- Western provides cellular phone service to subscribers in Western states, including South Dakota. South Dakota imposes its *sales* tax on all of Western's activities in South Dakota – taxing 100% of the revenues Western receives for all its activities and costs in connection with providing phone services to subscribers in that state (including the cost of CSC's billing service). SDCL 10-45-6.1.

2. Extraterritorial taxation – Respondent is silent.

Tellingly, Respondent's Opposition fails to address the extraterritorial imposition of its tax on services that were purchased, performed, received, and used in other states. This extraterritorial taxation is a fatal flaw targeted by the Commerce Clause's requirements of substantial nexus, nondiscrimination, fair apportionment, and fair relationship to services provided by the state. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 777-78 (1992) ("The principle that a State may not tax value earned outside its borders ... focuses on the guidelines necessary to circumscribe the reach of the State's legitimate power to tax"); *see* Pet. 12-13.

3. Respondent also ignores the multiple taxation of interstate commerce.

Those same four requirements aim to prevent another vice the Commerce Clause was intended to eliminate, multiple taxation of interstate commerce. Respondent's Opposition (at 10-15) skims through those requirements on the surface, but ignores the core problems those requirements are meant to solve. South Dakota's imposition of use tax on CSC's out-of-state services violates the Commerce Clause, both because it constitutes actual multiple taxation by South Dakota itself (by imposing both a sales tax and a

"compensatory use tax" on the same in-state activity), and because it subjects Western's use of an interstate billing service to the risk of multiple taxation by multiple states.

If, as South Dakota argues throughout, Western's business of providing ***phone services*** is considered a "use" in South Dakota of the ***billing services*** CSC performs in Illinois and California (Br. in Opp. 10), South Dakota has already fully taxed Western on that purported "use." The Opposition describes a connection between Western's cell phone business (conducted partly in South Dakota) and the billing services – performed by CSC and used by Western outside South Dakota. Western's cost of the billing service is, like all other costs, a component of its charge for cell phone service. South Dakota already imposes sales tax on all of Western's cell phone business in South Dakota, and specifically collects sales tax on Western's charges for cell phone service (of which its billing costs are a component).[1] South Dakota thus single-handedly subjects interstate commerce to multiple taxation.

As discussed in section A.4 *infra*, South Dakota's tax also subjects Western to the risk of multiple taxation, because other states are entitled to tax Western's use of billing services by virtue of the activities conducted in their states.

4. *Jefferson Lines* condemns, rather than supports, South Dakota's use tax in this case.

South Dakota incorrectly claims that the validity of its tax was "acknowledged" by the Court in *Oklahoma Tax Comm'n*

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[1] South Dakota's duplicative use tax on a component cost of Western's already taxed phone service is tantamount to imposing a tax on an automaker's deemed "use" of the engine it purchases when building a car sold to a South Dakota customer. Nor is there any reasoned basis on which to distinguish the billing services involved in this case from any other service a taxpayer outsources in the performance of its overall business – ranging from janitorial services for Western's Washington headquarters to software design services for new switches.

v. Jefferson Lines, Inc., 514 U.S. 175 (1995). Br. in Opp. 9. That case did not involve a use tax on services sold and performed entirely in other states. Rather it considered a sales tax on the in-state sale of a ticket for bus service that originated in-state and was performed partly in-state. As discussed in the Petition (at 10-11), *Jefferson Lines* explained that sales taxes survive Commerce Clause scrutiny because a sale "is most readily viewed as a discrete event ... consummated in *only one state* ... that could not be repeated in other States." 514 U.S. at 186-87 (emphasis added). There is no similar protection from multiple taxation in South Dakota's tax on the purported "use" in South Dakota of services that are performed entirely outside the state.

For tangible property there is one clear situs of use – at its physical location. In stark contrast, the states inconsistently perceive services (because of their intangible nature) to be "used" in many different locations, creating the risk of multiple taxation in each place of potential deemed use.[2] In the treatise on which Respondent relies, Professor Hellerstein expressly notes this contrast:

> [T]he rules regarding the appropriate place of taxation for cross-border sales of services are neither as consistent nor as well established as they are with respect to goods.

J. Hellerstein & W. Hellerstein, *State Taxation* ¶ 18.05[1] (3d ed. 2003). Some states tax services according to where they are performed; some tax according to where the purchaser is located; still others tax according to where the purchaser has

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[2] The constitutional significance of this difference is exacerbated by South Dakota's adoption of such an attenuated notion of the "use" of services. Both the Department and the state courts were explicit that the tax was *not* imposed on any "use" of the paper bills (the tangible manifestation of CSC's services) physically mailed into South Dakota; Western did not exercise sufficient dominion and control over the bills to trigger the state's use tax on tangible property.

access to the services; some tax according to where the services are "delivered" or where they are "enjoyed"; and a few states permit apportionment among the multitude of potentially taxable locations. *Id.*

The billing services at issue here were performed in Illinois and California, and were accessible and provided to Western only at its corporate headquarters in Washington (where it receives, reviews and approves the draft bills, which it cannot access in South Dakota). To the extent Western "uses" CSC's billing services by "getting paid" (Br. in Opp. 5, 10, 11), that "use" occurs in Arizona, where all payments are received and processed. Western is potentially subject to use tax on CSC's entire billing service in each of these states, creating a risk of multiple taxation.[3] As the Court confirmed in *Jefferson Lines*, there is a key constitutional demarcation between taxes on discrete events that occur (and are, therefore, only susceptible to tax) in a single jurisdiction versus taxes on activities subject to the taxing jurisdiction of more than one state. South Dakota's tax on Western's deemed "use" of billing services falls into the latter category because those services were performed, received, and "used" in states other than South Dakota.

Every one of those states has a right, superior to South Dakota's, to tax Western's purchase and use of this billing service. However, *Jefferson Lines* instructs that if only one state is to tax those billing services, it must be the state with a special relationship to the subject of the tax (not merely nexus), such as Illinois (where most of the services were

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[3] The Court has long held that the *risk* of multiple taxation is unconstitutional without the need to prove actual multiple taxation. *Armco, Inc. v. Hardesty*, 467 U.S. 638, 645 n. 8 (1984). Nor is the risk of multiple taxation negated by South Dakota's reciprocal credit mechanism. The Court has expressly condemned reciprocal credit limitations as unconstitutional. *Great Atlantic & Pacific Tea Company v. Cottrell*, 424 U.S. 366, 381 (1976).

performed and from which they were provided to Western) or Washington (where Western purchased, received and managed the services).

5. South Dakota's compensatory tax argument does not save its discriminatory imposition of use tax on out-of-state services.

South Dakota argues that its use tax survives Commerce Clause scrutiny as a compensatory tax. Br. in Opp. 12-14. This argument is wrong for several reasons. The starting point is South Dakota's mistaken claim that its use tax on services is not discriminatory. Br. in Opp. 4. As the Court has expressly held, use taxes are by nature discriminatory because they effectively apply only to out-of-state purchases (in-state transactions are subject instead to sales tax). *Fulton Corporation v. Faulkner*, 516 U.S. 325, 332 (1996). Discriminatory taxes can only be saved when offset by the countervailing impact of a compensatory tax, a claim subject to the "strictest scrutiny." *Oregon Waste Sys. v. Department of Envtl. Quality*, 511 U.S. 93, 99 (1994).

First, because there is no act or event in South Dakota by which Western uses the out-of state services (*supra*, at 2, 3), there is no event in South Dakota that is "substantially equivalent" to CSC's out-of-state performance of billing services. *Maryland v. Louisiana*, 451 U.S. 725 (1981).[4] Second, the activities Western performs in South Dakota are already subject to sales tax – there is no need for a use tax, which is duplicative, not compensatory.

Finally, the state's compensatory tax argument relies on taxes imposed on different taxpayers. Compare Br. in Opp. 13 (CSC would owe sales tax on its services if performed in

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[4] "To be sure, Louisiana has an interest in protecting its natural resources . . . But the First-Use Tax is not designed to meet these same ends since Louisiana has no sovereign interest in being compensated for the severance of resources [outside its borders]." 451 U.S. at 759 .

South Dakota) and 15 ("Western is the [use] taxpayer, not CSC."). *Jefferson Lines* teaches that taxes imposed on different taxpayers "diverge crucially" with respect to application of the Commerce Clause. 514 U.S. at 190.[5]

B. States continue to extend their reliance on use taxation of services, making the issue one of national importance.

Respondent asserts that Western "misread the Federation of Tax Administrators report," claiming that the national importance of the issue in this case is undermined because "*the rate of expansion* of the sales tax base to include services has *declined*" between 1994 and 1996 due to economic growth in the mid 1990s. Br. in Opp. 7 (emphasis added).[6] Notwithstanding cyclical changes in the *pace* of expansion, the FTA concluded that the continued expansion

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[5] In *Jefferson Lines*, the Court carefully distinguished between "standard" sales taxes "payable by the buyer" and other forms of gross receipts taxes "payable by the seller." 514 U.S. 179, n.3. The South Dakota decision also conflicts with an Arizona decision that recognizes the constitutionally significant distinction between a true sales tax imposed on the purchaser and a tax imposed on the seller/service provider. *Southern Pac. Transp. Co. v. Arizona*, 44 P.3d 1006, 1013 (Ariz. Ct. App. 2002) ("Although true 'sales' taxes have a similar appearance and effect, they are substantively distinct").

[6] South Dakota also quotes an excerpt from Professor Hellerstein's hornbook in its attempt to downplay the importance of the issue. Br. in Opp. 6. Ironically, the sentence preceding Respondent's quote expressly identifies the constitutional issue presented by this case:

> When states tax[] services where they are delivered or consumed rather than where they are performed – it can raise the *constitutional question* of whether a state in which the services are delivered or consumed possesses the power to tax services that are performed in other states.

J. Hellerstein & W. Hellerstein, *State Taxation* ¶18.06[2] (3d ed. 2003). The constitutional problem is much more pronounced when, as here, the services are not "delivered or consumed" in South Dakota, but are only perceived to benefit another (already taxed) activity.

is "inexorable." FTA Research Report No. 147, *Sales Taxation of Services*, 1996 Update at 11 (Apr. 1997). Moreover, the economic downturn since that report has created widely reported fiscal crises for all states and increasing pressure to expand their tax bases. As noted in the Petition (and ignored by Respondent), at least three states (Texas, Maine and Virginia) are currently considering substantial expansions of their sales and use tax bases to cover most services. The FTA report also explained that the pressure to expand the sales and use tax base is driven not only by current economic conditions, but also the continuing fundamental shift from a manufacturing to a service based economy. The Court's guidance on the proper application of the Commerce Clause to this increasingly prevalent form of taxation will help states to formulate constitutionally permissible tax systems to meet their fiscal needs, and protect interstate commerce from multiple and extraterritorial taxes that are not borne by local commerce.

CONCLUSION

For the reasons set forth above and in the Petition, Western respectfully requests that the Court grant certiorari to review the state court's decision.

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